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SUBJECT: MCC ELIGIBILITY: THE CASE FOR TIMOR-LESTE

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Summary

1. Timor-Leste is Asia's poorest country and ranks among the most impoverished nations of the world in terms of illiteracy, maternal and child mortality, malnutrition, low income and other indices of human development. Its infrastructure is shockingly poor, from roads to schools, to telecommunications and power generation. Timor-Leste's government is sharply aware of the need for development. Since coming into power in August 2007, it has established a record of maintaining stability in the face of extraordinary challenges (including the attempted assassination of both the president and prime minister in February 2008), has undertaken administrative reforms to combat corruption and improve the performance of the public service, and has designated 2009 as the year of infrastructure, with emphases on investment in public sector infrastructure, rural development and human capital. These three factors - great poverty, massive infrastructure needs together with a determination to govern competently - should make Timor-Leste a poster child for Millennium Challenge Corporation (MCC) Eligibility and a Compact.

2. Timor-Leste's MCC FY 2009 scorecard, however, is red on the crucial control of corruption indicator and in the category of investing in people, as it was in FY 2008. Given the time lag built into the MCC's indicators, the control of corruption finding reflects conditions in Timor in early 2007, well before the current government came to power, and well before it began to design and implement policies to combat corruption. Moreover, the data contained in Timor's indicators is very thin, generating huge margins of error, great imprecision and low confidence levels.

3. Another anomaly is Timor-Leste's Petroleum Fund, a sovereign wealth fund that collects revenues from the exploitation of the country's modest known natural resources, and represents the nation's sole potential source of significant, self-generated development finance. Now containing more than \$3 billion, the fund was deliberately and prudently established in 2005 to avoid the "resource curse" that has befallen other poor developing countries with the scourges of corruption, harmful resource allocation and poor investment decisions. Even if Timor-Leste chose to spend the modest sums in the Petroleum Fund now on public sector infrastructure projects, it could not efficiently or effectively do so given the absence of managerial, technical and engineering capacity throughout the Timorese economy. The nation is further hobbled by an ideological opposition to

international debt financing and outsourcing of project management. An MCC Compact, therefore, provides Timor-Leste with a critical opportunity to apply the highest standards of project design and management skills to its infrastructure needs, and to break the ideological barrier that prevents the importation of skilled, foreign project management.

¶4. We discuss below in turn Timor-Leste's current state of economic and social development, the Petroleum Fund and the government's efforts since August 2007 to improve policy and governance, particularly in the area of fighting corruption. We strongly urge the MCC Board of Directors to again extend eligibility to Timor-Leste and to permit the continuation of work towards a possible MCC Compact. The impact of a MCC Compact in Timor-Leste, both in terms of economic development but also on U.S.-Timor bilateral relations, will be profoundly positive. Conversely, the denial of eligibility will be a significant blow to Timor's prospects for sustainable medium term economic growth and seriously undermine the standing of the U.S. as a partner in the country's development. End summary.

Need

¶5. After six years of independence, Timor-Leste remains the poorest country in East Asia. Revenue generated from oil and gas reserves in the Timor Sea has nearly pushed Timor-Leste into middle-income status (see below), but non-oil income per capita, a more accurate measure of the plight of the average Timorese, was estimated at only \$440 in 2007. The most recent household poverty survey was undertaken in 2001 and published in 2003. It showed that 40 percent of the population lived below a poverty line of \$0.50 per day. Economic stagnation coupled with the world's highest fertility rate - nearly eight children per woman - led the UNDP to conclude in its 2006 Human Development Report that poverty had most likely increased since independence.

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¶6. Poverty is more prevalent in rural areas, where nearly three-quarters of the population lives; 44 percent live below the poverty line in rural areas compared to 25 percent in urban areas. With such a large rural population, it is not surprising that nearly 85 percent of the labor force makes its living from agriculture, yet agriculture only accounts for about 30 percent of non-oil GDP, an indication that productivity is extremely low. Indeed, according to the census published in 2004, over 45 percent of the population 15 years and older are subsistence workers. Only one percent of Timorese workers is engaged in any sort of "industry;" just four percent are employed in the private services sector. The employment demographics are frightening. Urban youth unemployment is estimated at forty percent. 15,000 new job seekers enter the market yearly, but a senior UNDP advisor recently estimated perhaps only 400 wage paying jobs have been created annually in recent years. (Note: World Bank representatives recently shared projections that perhaps 5000 jobs may be generated in 2008 if the government's budget is implemented as currently legislated; possibly 10,000 if a robust jobs program were instituted; and a strong shift to capital investment projects would be needed to get employment creation anywhere above 15,000.)

¶7. Income poverty is mirrored in other social indicators. The under-five mortality rate is 83 per 1,000 live births, and the maternal mortality rate is estimated to be between 420 and 800 per 100,000 live births, both of which are shockingly high. Malnutrition continues to afflict approximately half of all children under age five, a situation that has not improved since independence. 54% of the population is judged to be stunted and a quarter severely stunted. Cognitive skills throughout the population are very low. According to the 2004 census, more than half of the Timor-Leste's population aged six and older is illiterate. Nearly half of all adults have never attended a single day of school in their lives. Recent surveys indicate that the numeracy of the average Timorese Finance Ministry official is at the third grade level. Across the government,

the average public servant only completed the seventh grade. Taken together, these indicators help explain Timor-Leste's ranking of 150 out of 177 countries on the UNDP's Human Development Index, the lowest of any country in East Asia.

18. Finally, the country's infrastructure in all sectors remains woefully poor, whether it be transportation, energy, telecommunications, financial services, water and sanitation, health or education. Surveys indicate use of Timor's roads fell slightly since 2001, despite growth in population, as accessibility deteriorated with declining road quality. The use of roads to either bring agricultural goods to market or to purchase items fell significantly in the six years to 2007, by 29 percent and 25 percent, respectively. Electric power is unknown in most parts of the country or available only for short periods of the day. Only 1.5 percent of households have a land-line telephone connection. Just 1.3 percent of households use a bank and the market for insurance is non-existent. 72 percent of the population aged ten or above fetches water on a weekly basis and less than fifty percent of households have access to any type of installed sanitation facility. Fully 98.6% of households use wood for cooking and heating, and 67% of the population over ten years of age fetches wood at least once a week. Schoolhouses across the nation are renowned for their poor physical condition, lack of water and sanitation, absence of desks and books, and shortage of trained teachers.

Petroleum Fund

19. Timor-Leste's oil and gas resources offer an important means to address the discouraging picture painted by its socio-economic indicators. Current estimated petroleum wealth, based on the only field in operation, Bayu Undan, is \$13 billion. Production from Bayu Undan will peak in 2009 and be exhausted by 2023. It is estimated that a natural gas field (Greater Sunrise) could add up to \$10 billion to state coffers over the life of the project should production commence (operational requirements have not yet been finalized with a decision still pending over whether to pipe the gas to Australia, Timor, or to process it on a platform at sea). Potential revenue estimates of a recent discovery have not been developed, nor is it clear that exploitation is commercially feasible.

110. One of Timor-Leste's greatest policy achievements to date

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was the creation of a Norwegian-style Petroleum Fund in 2005 to create a patrimony and safeguard the country's economic prospects when oil and gas reserves eventually run out. As stated in legislation, the Fund's purpose is to "contribute to a wise management of the petroleum resources for the benefit of both current and future generations. The Petroleum Fund shall be a tool that contributes to sound fiscal policy, where appropriate consideration and weight is given to the long-term interests of Timor-Leste's citizens." All oil and gas revenue is deposited in the Fund, which takes a very conservative approach to investment. The Fund currently invests its assets entirely in U.S. Treasury bonds and custody is managed by a leading U.S. bank. The value of the Petroleum Fund has risen substantially with the record high oil prices seen in 2008. As of 30 June 2008, its assets were valued at \$3.2 billion, or over six times non-oil GDP.

111. Transfers from the Fund to the state budget typically finance upwards of 90 percent of planned Government expenditure, with the remainder coming from domestic taxes and user fees and charges. Such transfers are subject to a spending ceiling contained in law, known as "estimated sustainable income" (ESI), or interest income from estimated petroleum wealth. While the calculation of ESI uses conservative production and price projections, it, and, by implication, the Government's budget, is quite sensitive to changes in the price of oil. For example, a \$10 per barrel drop in the price of oil would have resulted in a \$67 million, or 17 percent, reduction in ESI in 2008.

Further, because ESI is based entirely on production from the only field currently in operation, a disruption at Bayu Undan would have grave consequences for the state budget.

¶12. Should the Government wish to transfer more from the Petroleum Fund to the state budget than ESI, parliamentary approval, in the form of a majority vote, is required. The Government had never sought to transfer more from the Petroleum Fund to the state budget than ESI until the mid-year budget revision in 2008, which proposed a transfer of \$687 million, or \$291 million more than ESI. The centerpiece of the budget revision was the creation of a \$240 million Economic Stabilization Fund to ensure political stability by cushioning the impact of rising commodity prices, especially rice (rice shortages in February 2007 led to political instability and violence in Dili). While the budget revision, particularly the Economic Stabilization Fund, initially raised a number of concerns about its fiscal direction, the government, following some disciplines imposed by the National Parliament in approving the budget, proved to be transparent in explaining its intentions. In fact, the government has exercised reasonable restraint in tapping the Economic Stabilization Fund. As of 30 September 2008, less than \$15 million of the Economic Stabilization Fund had been spent, all on rice.

Executive capacity

¶13. It cannot be overstressed that Timor-Leste's development has been hobbled primarily by its low level of executive, managerial, technical, engineering and absorptive capacity, and not by the constraints it has self-imposed through the creation of the Petroleum Fund. Since independence, governments have regularly been unable due to poor executive capacity to spend appropriated budgets, especially on capital projects. In the last fiscal year of the previous government, through summer 2007, the state spent only 16 percent of its capital budget, and just 55 percent overall. Through September 2008, the current government claims a higher spending achievement overall, but its record on implementing the arguably modest 2008 capital budget (equal to less than 20 percent of the budget) has remained weak, with only 14 percent expended on a cash basis through September 2008. Poor executive, managerial and leadership skills, mirroring Timor-Leste's low levels of educational attainment and cognitive skills, are endemic throughout the economy. Senior ministers regularly complain about the abject capabilities of Timor's private contractors. If the government sought now to spend a chunk of the Petroleum Fund on a large infrastructure project using local contractors, the result would be disastrous. Regrettably, political elites continue to cling to an ideology that requires that Timor's wealth should only be spent on Timorese. This has resulted in the country choosing not to take on international debt to finance development, but also its failure to acquire the foreign managerial, engineering and technical expertise needed to implement major infrastructure projects. This points to a potentially very beneficial outcome

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of an MCC Compact. The Finance Minister has openly discussed the path-breaking role MCC financing can play in demonstrating to Timorese the effectiveness of foreign management of a large infrastructure project, and thereby undermining the ideology that currently opposes project outsourcing.

FY 2009 MCA Scorecard

¶14. Timor-Leste's FY 2009 Millennium Challenge Account (MCA) "scorecard" is not markedly different from its FY 2008 scorecard. While Timor scores better than the median on half of the Ruling Justly indicators, it still does not pass the critical Control of Corruption indicator. The addition of the Natural Resource Management indicator in FY 2008 means it also does not pass at least half of the Investing in People indicators. The Immunization Rates, Girls' Primary Education Completion, and Natural Resource Management indicators all tend

to be structural variables that do not adjust quickly to policy changes, whereas Timor-Leste has consistently passed the two indicators that measure policy effort, Health Expenditures and Primary Education Expenditures. It is notable that data now exists for the Girls' Primary Education Completion indicator, and Timor-Leste's score is precisely at the median. Finally, the addition of data for the Trade Policy indicator means Timor-Leste now passes four of six Economic Freedom indicators.

¶15. As is well known, many of the MCA indicators suffer from lags in the data that may not reflect current performance. This is particularly true of the five indicators produced by the World Bank Institute that record performance in 2007, including the Control of Corruption indicator. In Timor-Leste, national elections were held in June 2007, and the current government only took office in August 2007. Prior to that, a caretaker Government led the country following the political and security crisis of 2006. As such, several of Timor-Leste's more problematic indicators likely reflect the consequences of the 2006 crisis and the caretaker government's performance, rather than that of the current government.

¶16. In addition, the five indicators produced by the World Bank Institute are estimates that have large associated margins of error due to the unavoidable uncertainty associated with measuring perceptions of governance. As the producers of the data note in the most recent edition of their data set, "a useful rule of thumb is that when confidence intervals for governance based on our reported margins of error overlap in comparisons of two countries, or a single country over time, this suggests that the data do not reveal statistically (or for that matter practically) significant differences in governance."

On this score, there has been no meaningful change in Timor-Leste's performance on any of the World Bank Institute indicators between FYs 2008 and 2009, nor, for that matter, since FY 2007, with the exception of a clear deterioration in performance on the Rule of Law indicator. This includes the Control of Corruption indicator, which Timor-Leste passed in FY ¶2007. Further, when one properly accounts for margins of error (with 90% confidence levels), Timor-Leste's scores on the Control of Corruption and Government Effectiveness indicators in FY 2009 may, in fact, be well above the median.

¶17. The very large margins of error associated with the five indicators produced by the World Bank Institute are a reflection of these indicators' sensitivity to changes in some of the underlying data sources, particularly in a data poor environment such as Timor-Leste. For example, the reported drop in Timor-Leste's performance on the Control of Corruption and Government Effectiveness indicators appears to be wholly attributable to one data source, the World Economic Forum Global Competitiveness Survey (WEF-GCS). The WEF-GCS index used by the World Bank Institute and incorporated in the FY2009 Timor-Leste scorecard is based on a survey conducted in March-May 2007, months before Timor's current government even came to power. The World Economic Forum recently issued the results of its 2008 survey, which are not reflected in the indicators produced by the World Bank Institute, and it suggests Timor-Leste may have improved in a couple of areas that affect its performance on the Control of Corruption indicator. For example, Timor-Leste's rank on the criteria of "public trust of politicians" improved from 86 out of 131 countries surveyed in 2007 to 71 out of 134 countries surveyed in 2008. Likewise, its rank on the criteria "favoritism in decisions of government officials" improved from 111 out of 131 countries surveyed in 2007 to 84 out of 134

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countries surveyed in 2008.

Efforts to Combat Corruption

Corruption Investigations

¶18. For the period 1 January to 31 October 2008, the Office of

the Prosecutor-General initiated 23 new investigations into allegations of corruption, a pace of investigation virtually identical to 2007, when a total of 27 cases were initiated. However, unlike 2007, two cases have thus far been taken to court in 2008. An international prosecutor was recently hired to focus on corruption cases, which should assist with case processing. For its part, the independent Office of the Provedor (Ombudsman) for Human Rights and Justice initiated 19 corruption investigations in 2008 through 30 September, whereas 14 investigations were initiated in all of 2007. The Provedor has to date referred three corruption cases to the Prosecutor-General for further action, one of which has resulted in an indictment. The Government, too has taken some steps to punish corruption, suspending eight national police officers for 90 days without pay for their roles in the disappearance of \$27,000. In August 2008, the Prime Minister dismissed two senior civil servants in the Ministries of Health and Infrastructure on grounds of corruption, referring the cases to the Prosecutor General. There is an ongoing inquiry into the Minister of Justice's possible role in referring no-bid contracts to her husband's construction firm.

Year of Administrative Reform

¶19. The Government declared 2008 to be the "Year of Administrative Reform." In practice, this meant the launch of three new initiatives intended to combat corruption and strengthen the integrity of the civil service. The first initiative is the creation of an independent Anti-Corruption Commission, a commitment the Prime Minister made in his inaugural policy address in August 2007. Legislation creating the Commission was sent to Parliament on 24 October 2008 for consideration, and, expecting that it will become operational on 1 January 2009, the Government has included funds for the Commission in its draft 2009 budget. The law establishing the Commission repeals the Provedor's anti-corruption mandate and provides the Commission with certain powers that the Provedor currently lacks. These include the authority to freeze bank accounts and other assets, restrict international travel, and intercept communications (jointly with the Prosecutor-General), among others. Like the Provedor, the Commission will report to Parliament and, as such, be independent of the Government. However, also like the Provedor, its budget will pass through the Ministry of Finance, and it will be subject to the same human resource policies and salary scales that apply to the rest of the civil service.

¶20. Senior policy advisors to the Prime Minister recognize that the Anti-Corruption Commission is only one piece of a comprehensive national anti-corruption strategy and cannot substitute for an overall environment of stability and effective governance. That is why the Anti-Corruption Commission is complemented by two other initiatives, the creation of an independent Civil Service Commission and the establishment of an external auditor, and why the Prime Minister has requested a USAID advisor to assist with the development of a national anti-corruption strategy. The Civil Service Commission will set performance, training, and development standards for public servants and be given the authority to appoint senior civil servants. Like the Anti-Corruption Commission, the Civil Service Commission will report to Parliament, though it too will submit its budget request through the Ministry of Finance. Legislation establishing the Civil Service Commission has been sent to Parliament for consideration, and funds for a January 1, 2009, commencement are included in the draft 2009 budget.

¶21. The creation of an external auditor is the only one of the three Year of Administrative Reform initiatives that has not made significant progress. Initially, this was thought to be the easiest of the three measures to implement; the Government planned to transform its existing internal auditor, the Office of the Inspector General, into an Auditor General reporting directly to Parliament. However, the proposal was challenged by the judiciary, which noted the constitution assigns the external audit function to a High Audit and Tax Court. Though the Court

does not yet exist, draft legislation is reportedly under preparation by the Ministry of Justice.

¶22. Separately, the National Parliament took steps to boost the country's anti-corruption effort, hosting in September 2008 a public forum toward the goal of creating a nationwide anti-corruption network. The featured speaker was the chair of Indonesia's anti-corruption commission, and our ambassador participated also. The national parliament will soon complete debate on Timor's first comprehensive penal code, intended to bring order to the overlapping and occasionally contradictory Portuguese, Indonesian and UN criminal codes that are currently in force. The draft penal code includes nine provisions on corruption. According to the Prosecutor General, once passed the penal code will give him substantially more legal clarity and authority to bring indictments against public officials accused of corrupt practices. And Mission Dili is doing our bit: with USAID support, we are in the final stages of hiring an advisor to work directly for the Prime Minister as he shapes his anti-corruption policies and practices.

Internal Controls

¶23. In the absence of strong audit capacity in Timor-Leste, the Ministry of Finance has taken the initiative to commission a series of process reviews and audits by Deloitte using its own budget. This reflects the view of the Minister of Finance that some of the most effective anti-corruption measures that can be taken are those that tighten internal controls. The first review was a detailed examination of the procurement process, and it led to a procurement reform strategy, which will decentralize procurement to line ministries, properly train and accredit civil servants involved in the procurement process, and strengthen the oversight role of the central procurement unit within the Ministry of Finance. The international accounting firm Deloitte now has a contract to complete ten additional reviews that generally target revenue-generating programs managed by the Ministries of Education, Infrastructure, and Justice.

International Agreements

¶24. The Government of Timor-Leste recently approved the UN Convention against Corruption and has sent it to Parliament for ratification. In addition, Timor-Leste remains one of only two countries in East Asia that has signed up to the Extractive Industries Transparency Initiative (the other is Mongolia). The disciplines surrounding the Petroleum Fund are the clearest evidence of Timor-Leste's commitment to the Initiative. The Fund was ranked fifth out of 34 similar sovereign wealth funds from all over the world - and third in the category of Accountability and Transparency - by the Peterson Institute for International Economics in April 2008 for its adherence to management best practices. In addition to the spending ceiling on Fund assets (see above), the Banking and Payments Authority (BPA), Timor-Leste's quasi-central bank which manages the Petroleum Fund, is required to issue quarterly public reports on the status of the Fund, and the Fund undergoes regular internal (by BPA) and external (by internationally recognized accounting firms) audits.

Overall Governance Performance

¶25. The current government came into power in August 2007 with a five year mandate and the policy goals of administrative reform, promoting the country's development and overcoming the legacies of the 2006 crisis (when, precipitated by a mutiny in its military by a group of 400 "petitioners," the government eventually collapsed, the military and police engaged in open, deadly combat on the streets of Dili and 15 percent of the population became homeless in the violence and lawlessness that ensued). The government faced an extraordinary challenge on February 11, 2008, when both the president and the prime

minister came under gunfire, with the president critically wounded. In response, Timor-Leste's institutions performed well. In strict accordance with the constitution and law, and in consultation with the national parliament and people, the government imposed a state of emergency. It united the military and police under a joint command that eventually compelled the peaceful surrender of the 2/11 perpetrators. Since the first half of 2008, the government has accelerated programs to close

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IDP camps and reintegrate families back into their communities. It resolved the grievances of the petitioners. The government introduced a pension program for veterans and the elderly. Crime levels have fallen substantially. With U.S. support, the government launched the drafting of a national security policy that will provide the legal basis for a thorough reform of the nation's security institutions. In recognition of the stability that has been engendered, the Department of State in September 2008 lifted a travel advisory for Timor-Leste that had been in place since May 2006. In October 2008, the Australian government, also pointing to Timor-Leste's stability, announced it would reduce its troop strength in Timor by 100, nearly a 15 percent reduction in force.

Working Toward an MCA Compact

¶26. The Government of Timor-Leste has clearly demonstrated its commitment to obtain an MCA compact. It created a unit within the Ministry of Finance, staffed with highly capable individuals and allocated with a robust six-month budget of \$750,000, to monitor government policy that impacts the MCA indicators and lead the Government's efforts to enter into a compact with the MCC. Steps toward the latter included the preparation of a rigorous constraints analysis, which employed state-of-the-art growth theory and empirical techniques to identify the key obstacles to economic growth; a substantive, two-month consultation process that covered the entire country and generally validated the results of the constraints analysis; and the preparation of two concept papers for programs targeting road infrastructure and vocational education (a third, requested by the MCC targeting anti-corruption, is currently under development and should be submitted by mid-November 2008). The Government's MCA team was extremely diligent in meeting all of the MCC's deadlines at each stage in the process and has been allocated an additional \$300,000 to commence feasibility studies by the government.

¶27. Because the MCC identified the lack of a broad-based consultation as a major shortcoming of the previous Government's compact proposal (see Dili 109), some additional comments on the recent consultation process are warranted. Over a three-month period, the Government's MCA team organized consultations with all elements of Timorese society, including various NGOs, youth organizations, the religious community, women's groups, the private sector, research institutions, and the international community. Four regional sessions, grouping representatives from two to four districts, and a dedicated meeting for the isolated enclave of Oecusse, were held outside the capital. Embassy officers, including the ambassador, participated in several consultations. The Government's MCA team hoped to reach 1,500 people directly through the consultations and thousands more through word of mouth and media events. In total, 1,309 people participated in consultations, of which over 800 participated through the regional consultations. Nearly 20 percent of participants were women, a reasonable share given the dominance of men in village governance.

¶28. The most recent consultation took place on October 30 when the MCA team, joined by the ambassador, held its third in a series of meetings with the National Parliament. Fifteen deputies attended (just short of a fourth of the entire body), including representatives from every party, several party bench chairs, the speaker of the parliament, and key commission chairmen. One of the most notable things to emerge from the consultation process was the public's interest in the issue of

corruption. The MCC scorecard has clearly served to stimulate discussion down to the village level about the importance of tackling corruption for the nation's development, a worthy achievement for the MCC model. Another common refrain was a plea for quality: if the MCC invests in a national road network, many members of the public asked for assurances that the outcome would be a well engineered and maintained system designed to provide a lasting and qualitative improvement over the nation's current road system - in open contrast to the patchwork of occasionally poorly designed and implemented road projects the government and other donors have funded. Timor-Leste's MCA team intends to hold a second phase of consultations this month to provide feedback to communities regarding the concept papers submitted to the MCC.

Conclusion

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¶29. Despite its significant natural resource wealth, Timor-Leste is the poorest country in East Asia. It has commendably established an arrangement to protect its resource wealth for the benefit of future generations in its internationally recognized Petroleum Fund. An MCC program would help the Government speed up implementation of much-needed capital investments while perhaps reducing some of the pressure to spend beyond its current capacity to execute sound development programs. In addition, an MCC program will provide a useful model to counter the widespread ideological opposition to outsourcing project implementation until such time as the Timorese are able to better develop their own internal capacity (see Dili 159). In sum, the impact of a MCC Compact in Timor-Leste, both in terms of economic development but also on U.S.-Timor bilateral relations, will be profoundly positive. Conversely, the denial of eligibility will be a significant blow to Timor's prospects for sustainable medium term economic growth and seriously undermine the standing of the U.S. as a partner in the country's development.
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